Overview

Vulnerabilities in parts of the global banking system have been exposed but the broader global banking system has remained resilient

Global financial stability risks have increased despite loan arrears remaining very low. Some regional banks in the United States failed in March because of weaknesses in their business models and risk-management practices. Heightened risk aversion led to an increase in volatility in some financial markets and to liquidity stress transmitting to other parts of the international banking system. This culminated in the regulator-facilitated takeover of Credit Suisse by UBS, following a lengthy period of concerns being raised about Credit Suisse's underlying profitability, risk controls and governance practices.

In the face of these high-profile bank failures – the most severe banking-system stress event since the global financial crisis – the broader global banking system has remained resilient. This has been supported by the prompt actions of authorities and earlier reforms ensuring that large banks maintain high levels of capital and liquidity. Regulators moved quickly to address the failing banks and, following a step-up in liquidity operations by central banks, financial conditions have stabilised.

A key risk is that a further substantial tightening in financial conditions leads to disorderly declines in asset prices and disruptions to financial system functioning

Confidence in some banks remains fragile – particularly those with business models that leave them susceptible to deposit flight – and if further stresses were to affect banks around the world, it would feed through to tighter financial conditions. Another catalyst for a sharp tightening in financial conditions would be financial market participants reassessing the likelihood of a soft landing. This could occur if inflation remains persistently high and financial markets price in a further substantial tightening in monetary policy in large advanced economies. Large and disorderly declines in financial asset and property prices resulting from higher interest rates and increased risk aversion could disrupt key funding markets and strain the balance sheets of some borrowers and lending institutions. Further increases in borrowing costs and reduced supply of credit to households and businesses could also accelerate a downturn in the broader credit-quality cycle. Indeed, the combination of tighter monetary policy, high inflation and slowing economic growth is already squeezing the cash flow positions of some households and businesses worldwide.

There is also the ongoing risk that any disruption in financial system functioning is amplified by liquidity mismatches at leveraged non-bank financial institutions – a risk highlighted by several events in recent years and one that remains a key area of international supervisory focus.

The recent strains experienced in parts of the global banking system are likely to prompt banking regulators to revisit how best to ensure banks remain resilient to shocks in the digital era. This includes considering measures to forestall the risk of particularly rapid deposit runs. Recent events have also highlighted a number of other issues, including: risks relating to non-systemic institutions generating systemic spillovers; the possibility that the regulation and intensity of supervision of small banks may need to increase; and the need to continue international progress on resolution regimes.

The Australian financial system remains strong and well placed to support the economy

Australia is not immune from the deteriorating outlook for global financial stability; volatility in domestic financial markets picked up in March alongside developments abroad. However, the Australian financial system entered this more challenging period in a strong position and is well placed to continue supporting the domestic economy. Banks are well regulated, strongly capitalised, profitable and highly liquid. This leaves them well positioned to continue lending to Australian households and businesses. In recognition of recent global developments, the Australian Prudential Regulation Authority (APRA) has intensified its oversight of domestic financial institutions and together with the Bank and other Council of Financial Regulator agencies, is closely monitoring for any adverse effects on the broader financial system. Like other regulators around the world, APRA is also considering the lessons that should be drawn from recent events. It is important that financial institutions in Australia continue to invest in their capacity to absorb shocks by maintaining strong capital and liquidity buffers and increasing their operational resilience, including to external threats like cyber-attacks.

Most households and businesses are resilient to the challenging economic environment, but this resilience is unevenly spread

Most Australian households and businesses are well placed to manage the impact of higher interest rates and inflation, supported by continued strength in the labour market and higher savings buffers. But this resilience is unevenly distributed. Some households and businesses are already experiencing financial stress, and the squeeze on household budgets is likely to continue for some time. The households most affected have been those on lower incomes, including many renters, and relatively recent borrowers who have larger debts (relative to income) and have had less time to build up savings buffers. Smaller businesses have more variable-rate debt and volatile income compared with larger firms, and so are more exposed to rising interest rates, while some building construction firms have faced ongoing margin pressures as a result of fixed-price contracts written before the sharp increase in input and labour costs. These businesses have accounted for a large proportion of the recent increase in company insolvencies. While insolvencies have returned to their pre-pandemic level, banks' non-performing business loans remain very low.

An increase in the share of households and firms falling into arrears on their loans is anticipated by lenders, but any increase in non-performing loans will be occurring from a very low level. Further, the share of banks' loans in or close to negative equity is negligible, which helps limit the losses to both borrowers and banks in the case of default. This reflects the generally sound lending standards and the large run-up in housing prices over recent years. The decline in national housing prices over the past year has only partially reversed the earlier gains, and even if housing prices were to fall by as much again, the share of loans in negative equity would remain very low. If unemployment was to rise more sharply than expected, the share of households and businesses experiencing financial difficulties – and ultimately falling into arrears on their loans – would increase further still. Even then, stress-testing exercises continue to suggest that banks would remain resilient.

Threats from outside the financial system continue to pose risks to financial stability

Beyond the near-term risks to financial stability, there are other medium-term threats generated from outside of the financial system that warrant ongoing attention from financial institutions and authorities in Australia and around the world. These include the increasing intensity of cyber-attacks on financial institutions, the potential for an escalation in geopolitical tensions that results in disruptions to trade and international capital flows, and potential climate-related disruptions to parts of the financial system (including but not limited to energy markets). How these risks might interact is an additional source of uncertainty.